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No. 61

# In the Supreme Court of the United States

OCTOBER TERM, 1935

JOHN A. NELSON COMPANY, PETITIONER

*v.*

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

*ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT*

## BRIEF FOR THE RESPONDENT

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## BRIEF FOR THE RESPONDENT

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### OPINIONS BELOW

The opinions of the United States Board of Tax Appeals are reported in 24 B. T. A. 1031 (R. 26–39) and 28 B. T. A. 529 (R. 45–61). The opinion of the Circuit Court of Appeals is reported in 75 F. (2d) 696. (R. 74–78.)

### JURISDICTION

The judgment of the Circuit Court of Appeals was entered February 23, 1935. (R. 78.) The petition for a writ of certiorari was filed May 20, 1935,

and granted October 14, 1935. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

### QUESTION PRESENTED

Whether the term "reorganization" as used in Section 203 (h) (1) of the Revenue Act of 1926 includes a transfer by one corporation of substantially all its assets to another corporation in exchange for cash equivalent to the value of the tangible assets and preferred non-voting stock callable at the option of the transferee.

### STATUTE INVOLVED

The pertinent provisions of the statute involved are contained in the Appendix, *infra*, pp. 18–19.

### STATEMENT

The facts were stipulated (R. 12–26) and may be summarized as follows:

The petitioner is an Illinois corporation, with its principal office at Rockford, Illinois. During the years 1924 to 1926, inclusive, it was engaged in the manufacture and sale of milling and adding machines under the name of Rockford Milling Machine Company. In June, 1926, the name of the corporation was changed to Sundstrand Corporation, and in December, 1926, its name was further changed to John A. Nelson Company. (R. 12–13.)

On November 18, 1926, the petitioner and Elliott-Fisher Company, a Delaware corporation, entered

into an agreement (R. 13–22), wherein the petitioner agreed to convey and transfer to a new corporation to be formed by the Elliott-Fisher Company all of its assets, including patent accounts and accounts and notes receivable (with the exception of $100,000 cash) (R 14–17). The new corporation to be organized by the Elliott-Fisher Company was to have a presently issued capital stock consisting of 12,500 shares of $7 preferred stock of the par value of $100 each, with no voting privileges unless dividends thereon should be in default in the amount of at least $7 per share, and 30,000 shares of common stock without nominal or par value, each share of common stock carrying one vote. (R. 14–16.) Provision was made for the issuance of such additional shares of preferred stock as should be necessary in settling for the profits of petitioner before the closing date. (R. 16.)

The Elliott-Fisher Company also agreed that simultaneously with said transfer it would cause the new corporation to issue to, or in accordance with the direction of, the petitioner 12,500 shares of the $7 preferred stock of the new corporation and to pay to the petitioner $2,000,000 in cash. It was understood that the new corporation was to assume all of petitioner's ordinary obligations. (R. 17.) Simultaneously with, or at the option of Elliott-Fisher Company before, said transfer of petitioner's property to the new corporation, Elliott-Fisher Company agreed to cause the new cor-

poration to issue to Elliott-Fisher Company 90,000 shares of its common stock upon the payment therefor by Elliott-Fisher Company of $2,000,000 in cash. (R. 18.)

It was also understood that the new corporation could, at its option, use the name Sundstrand Corporation or Sundstrand as, or as a part of, its corporate name and that the petitioner would, when and as requested by the new corporation or Elliott-Fisher Company, make any necessary change in its corporate name so that the new corporation could be in a position to register to do business in any State in the United States. (R. 19.)

On November 18, 1926, at a special meeting of the petitioner's stockholders, called for the purpose of considering and acting upon the proposition made to it "to sell and dispose of all of its property and assets". (R. 22–23) aforesaid, the following resolutions were adopted (R. 23–24):

> Resolved that the Stockholders of the Company in meeting duly assembled hereby approve said Agreement, and authorize and direct the sale and transfer of all the property and assets of this Company upon the terms and conditions therein provided; and further
>
> Resolved that the Board of Directors and officers of this Company be and they hereby are authorized and directed to take such steps and to execute such instrument or instruments including said Agreement, with

such modifications thereof or supplements thereto, as in their opinion may be necessary or desirable in order to effect such sale and transfer; and further

Resolved, that upon the consummation of said reorganization and sale, the proceeds consisting of preferred capital stock and cash received from such sale be distributed immediately to the stockholders in the order of their preferential rights, the preferred stock being first fully redeemed and the balance distributed to the common stockholders; and further

Resolved, that this corporation, after the consummation of said re-organization and sale under the said agreement with Elliott-Fisher Company and the distribution of the proceeds in accordance with the reorganization plan to its stockholders in the manner provided above, shall cease operation, and the directors and officers thereof shall proceed to liquidate the corporation and cause the same to be dissolved.

At the same meeting the petitioner's name was changed to John A. Nelson Company. (R. 24.)

On December 31, 1926, pursuant to the terms of the agreement with Elliott-Fisher Company, all of the petitioner's properties (R. 13), with the exception of $100,000 in cash (R. 17), were transferred to a new corporation known as the Sundstrand Corporation of Delaware, and the petitioner received therefor 14,060 shares of the preferred stock of the

new corporation and $2,000,000 in cash (R. 13). The petitioner immediately used part of the cash so received to retire its own preferred stock and distributed the 14,060 shares of the new company's preferred stock and the balance of the cash to its common stockholders. (R. 13.) The petitioner, however, was not dissolved.

No gain or loss was recognized or reported by the petitioner in its 1926 income tax return with respect to the transaction referred to above. As of the date of the said transaction, however, the books of the petitioner showed a reserve for unrealized profit on installment sales in the amount of $322,980.29. This sum the respondent added to the petitioner's income, in arriving at the deficiency here in question, on the ground that the petitioner collected, when it exchanged its assets for stock and cash, 100% for the total outstanding installment accounts receivable. (R. 13.)

In the proceedings before the Board of Tax Appeals the facts were stipulated. The stipulation contained the following conclusion: "On December 31, 1926, petitioner was a party to a reorganization * * *." (R. 13.) This conclusion formed the basis of a division report promulgated November 30, 1931. (R. 26–39.) On December 19, 1931, pursuant to the provisions of Section 601 (b) of the Revenue Act of 1928, an order was entered by the Board on its own motion directing that the division report be reviewed by the entire Board.

(R. 39.) On June 23, 1933, the entire Board, with the exception of one dissent, sustained the respondent's determination and held that the transaction in question did not constitute a reorganization within the meaning of Section 203 (h) of the Revenue Act of 1926. (R. 45–61.)

The Circuit Court of Appeals affirmed the decision of the Board of Tax Appeals. (R. 78.)

## SUMMARY OF ARGUMENT

1. The definition of "reorganization" upon which petitioner relies is contained in the same parenthetical clause discussed in the brief for petitioner in *Guy T. Helvering, Commissioner of Internal Revenue,* v. *Minnesota Tea Company,* No. 174, present term. For the reasons there stated, we contend that the definition should be limited to mergers and consolidations or to transactions which partake of their nature.

2. The transaction here involved fails substantially to conform to certain basic elements found in mergers and consolidations. There was no plan of reorganization; petitioner received no stock or securities within the meaning of the statute; the proportion of cash to stock interest was so large that petitioner's proprietary interest was substantially changed; petitioner's liabilities were assumed only in part by the new company; and petitioner did not dissolve. Petitioner received cash equivalent to the value of its tangible assets, and received in addition only preferred stock callable at the option of

the transferee and having no voice in the management. We submit that petitioner's relationship to its assets was vastly different after the transaction and that such a substantial change does not constitute a reorganization.

## ARGUMENT

### I

THE STATUTE CONTAINS TWO OVERLAPPING DEFINITIONS OF "REORGANIZATION." THEY CAN BE RECONCILED ONLY BY RESTRICTING THE CLAUSE (A) DEFINITION TO TRANSACTIONS WHICH RESULT IN MERGERS OR CONSOLIDATIONS OR PARTAKE OF THEIR NATURE

The general rule of the statute is that gains upon exchanges are taxable. To this there are certain strictly defined exceptions. Petitioner contends that the transaction here involved is literally within the language of one of the exceptions (Section 203 (b) (3), Revenue Act of 1926 (*infra*, p. 18), as modified by Section 203 (e) (*infra*, p. 18)). Section 203 (b) (3) provides in substance that the gain will not be recognized where a corporation a party to a reorganization exchanges property in pursuance of the plan of reorganization solely for stock or securities in another corporation a party to the reorganization. Section 203 (e) provides for the case where money or property other than stock or securities enters into the transaction. The case turns upon whether the transaction involved was a "reorganization." The portion of the definition of reorganization upon which petitioner relies is as follows (Section 203 (h) (1)):

> The term "reorganization" means (A) a merger or consolidation (including the acquisition by one corporation of * * * substantially all the properties of another corporation * * *.

The Government contends that the parenthetical language upon which petitioner relies is colored and controlled by the words "merger or consolidation" and that to be within the definition a transaction must partake of the nature of a merger or consolidation, though it fails to satisfy all of its legal requirements. This contention is fully developed in the brief for petitioner in *Guy T. Helvering, Commissioner of Internal Revenue*, v. *Minnesota Tea Company*, No. 174, present term, and Point I of the Argument in that case is therefore incorporated herein by reference.

Petitioner contends that a strict construction of the statute will widen the field of losses, and hence that a liberal construction which will have the effect of postponing gains will be offset by a similar postponement of losses. This reasoning is unsound. The difficulty with a liberal construction of the statute is that it makes taxability depend entirely upon the procedural steps which are taken—that is, upon the mere form in which the transaction is cast. Since the form of the transaction can always be altered to suit the convenience of the taxpayer, the liberal construction of the statute permits transactions which are really sales to be deliberately brought within the statute by careful adherence to

the procedural requirements. But where a loss is involved the taxpayer can avoid the procedural steps which would make the transaction a reorganization and can carry out the transaction in such a manner that the loss will be allowable. Accordingly, the same transaction can be brought within the statute or not, depending upon whether a gain or a loss is involved. We submit that a more penetrating test is required and that the statute should not be exposed to manipulation by making the form of the transaction the test of taxability. The following excerpt from the dissenting opinion in the *Minnesota Tea Co.* case (76 F. (2d) 797, 805) is apposite here:

> If it is the law, it would be folly to close any large sale without including some of the purchaser's stock in the purchase price, especially as in this case, where the purchaser's stock was for sale on the New York Stock Exchange. Though the tax on gains from sales is not repealed, none but the simple would need to pay it.

## II

### THE TRANSFER TO THE NEW CORPORATION DID NOT SUFFICIENTLY PARTAKE OF THE NATURE OF A MERGER OR CONSOLIDATION TO BE TREATED AS A REORGANIZATION

In substance, the transaction which petitioner contends is a reorganization within the statutory language "the acquisition by one corporation of

* * * substantially all the properties of another corporation", is as follows: In 1926 petitioner was engaged in the manufacture and sale of milling and adding machines. In November of that year it entered into an agreement with the Elliott-Fisher Company whereby the latter undertook to organize a new corporation to acquire the assets of petitioner. The Elliott-Fisher Company agreed to purchase the entire issue of common stock of the new company for $2,000,000 cash. Petitioner agreed to transfer substantially all of its property in consideration of $2,000,000 and the entire issue of preferred stock of the new company. This transaction was consummated pursuant to the agreement, and petitioner used part of the cash to retire its own preferred stock and distributed to its common-stock holders the balance of the cash together with the preferred stock of the new company.

We think the transaction fails to satisfy the statute in several particulars: (1) there was no plan of reorganization; (2) petitioner received no "stock or securities" within the meaning of the statute; (3) the proportion of cash to stock interest was so large that petitioner's proprietary interest was substantially changed; (4) petitioner's liabilities were assumed only in part by the new company; (5) petitioner did not dissolve.

We shall briefly discuss each of the points enumerated above.

(1) The record evidences a plan of sale rather than a plan of reorganization. While the trans-

action resulted in the creation of a new corporation, it was not the successor of petitioner and the Elliott-Fisher Company. The petitioner transferred assets to the new company but the Elliott-Fisher Company did not transfer any business property. The latter merely made a cash investment in the new company, whose assets consisted of those transferred by the petitioner. The Elliott-Fisher Company caused the new company to be organized (R. 14), with such powers, charter provisions, and bylaws as Elliott-Fisher Company deemed necessary or advisable (R. 16). The new company was the representative of the Elliott-Fisher Company in the transaction and it was no part of the plan that the new company should succeed to any of petitioner's corporate rights except its name. The new company's relation to petitioner was that of a purchaser of its assets. The agreement described the transaction as a purchase. (R. 16.) The proposed agreement between petitioner and the Elliott-Fisher Company was submitted to the stockholders of petitioner as a plan (R. 23) "providing for a reorganization upon the terms and conditions therein stated and for the sale and transfer of all of the property and assets of this company." The resolution adopted by petitioner's stockholders approved the agreement and authorized (R. 23) "the sale and transfer" of petitioner's assets. Another resolution authorized the Board of Directors to execute such instruments

as should be necessary or desirable "in order to effect such sale and transfer." (R. 23.) While the resolutions employed the term "reorganization", as well as the term "sale", the two are wholly inconsistent. The record does not contain the instrument of actual transfer but the authority given to the Board of Directors would seem to contemplate a bill of sale. The Board of Tax Appeals held that the agreement was a contract of sale. (R. 59.) The Circuit Court of Appeals held that the transaction essentially constituted a sale. (R. 76.)

(2) In exchange for its assets petitioner received $2,000,000 in cash and 14,060 shares of preferred stock in the new company. (R. 52.) This stock carried no voting rights except in the event of default in the payment of dividends. (R. 15.) It was callable in whole or in part on any dividend date at the option of the new corporation. (R. 14.) Accordingly the preferred stock gave petitioner no voice in the management of the company which acquired its assets and it was within the power of the new company to eliminate whatever proprietary interest was represented by the preferred stock. It is settled that a corporation which transfers its assets to another in a reorganization must preserve a continuity of interest in the assets by securing an intimate interest in the affairs of the transferee. *Pinellas Ice Co.* v. *Commissioner*, 287 U. S. 462.

Since the statute recognizes as a reorganization a transfer solely for stock or securities (Sec. 203 (b) (3), *infra*, p. 18), it seems logical that the required continuity of interest should be represented by the required stock or securities. A corporation which transfers its assets for stock or securities which represent no voice in the management has clearly parted with an essential element of its proprietorship. Such an exchange results in a substantial change in the transferor's position and would seem to be beyond the purview of a statute designed to relieve formal changes from the tax.

In view of the clause (B) definition of reorganization, which covers a transfer of assets in exchange for a controlling interest in the transferee, it is clear that Congress was unwilling that a corporation which parted with its assets should change its position so radically that it lost substantial elements of direct ownership. Fitting the requirement for receiving "stock or securities" into such a pattern, it seems entirely logical that in order to satisfy the clause (A) definition the term "stock or securities" should be limited to evidence of ownership which gives a voice in the management. The Board of Tax Appeals held that this nonvoting stock represented little more interest in the affairs of the acquiring corporation than did the notes in the *Pinellas* case. (R. 60.) The Circuit Court of Appeals held that the preferred stock did not represent a continuity of interest (R. 76), and

we submit that it did not represent "stock or securities" within the meaning of the statute.

(3) The 14,060 shares of preferred stock had a par value of $100 each (R. 14), and accordingly represented $1,406,000. In addition, petitioner received $2,000,000 in cash. Petitioner's tangible net worth was in excess of $2,090,000 (R. 18), and since it withheld from the transfer $100,000 in cash, it is evident that the $2,000,000 cash received from the new corporation was substantially the value of its assets. At least it is clear that the $1,406,000 in preferred stock was not equivalent in value to the assets transferred by petitioner. As explained in the brief for the petitioner in the *Minnesota Tea* case, *supra*, cash and property other than stock or securities were permitted to enter into a reorganization only as "boot", and we therefore submit that proportion of cash to stock and the disparity between the value of the new stock held by the petitioner after the transfer and the value of its assets before the transfer is so great that this transaction resulted in a substantial change in its position. The transaction has all the aspects of a sale of petitioner's assets for cash, with preferred stock added as a bonus. We submit that only by giving the statute a literal application and departing from the principles which actuated Congress in enacting the reorganization provisions, can this transaction be said to be a reorganization.

(4) The new corporation assumed all the ordinary liabilities of the character and approximate

amount shown on the balance sheet attached to the agreement. (R. 17, 22.) The new corporation was specifically protected against all other liabilities. Petitioner agreed to assume liabilities for certain bonuses (R. 19) and tax liabilities (R. 20). As pointed out in the brief for petitioner in the *Minnesota Tea* case, *supra*, it is one of the indicia of a merger or consolidation that the successor corporation assumes all of the liabilities of the predecessor companies, and the limitation of liability here serves to emphasize the point that petitioner's corporate business was not merely continued in a new form. It was a new and distinct enterprise, just as widely separated from petitioner corporation as though it had purchased petitioner's assets exclusively for cash.

(5) Although the stockholders of petitioner adopted a resolution to cease operations and authorized the directors and officers to proceed to liquidate the corporation and cause its dissolution (R. 24), it is significant that the record shows no action taken pursuant to such authority. Petitioner still exists as a corporation, and at the same meeting at which dissolution was authorized the name of the petitioner was changed. (R. 24.) The Board of Tax Appeals pointed out (R. 60) that the agreement with the Elliott-Fisher Company looking to the change of name and the action of the stockholders pursuant thereto apparently contemplated the continuance of petitioner's corporate ex-

istence. We have contended in the *Minnesota Tea* brief that a reorganization should at least contemplate the dissolution of the predecessor corporation, but we do not think such a requirement is satisfied by the minutes of a stockholders' meeting which after nine years remain merely a resolution which has not been acted upon.

## CONCLUSION

In view of the foregoing, we submit that the transaction here involved was not a reorganization, and that the decision of the Circuit Court of Appeals should be affirmed.

Respectfully submitted.

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NOVEMBER, 1935.

# APPENDIX

## STATUTE INVOLVED

Revenue Act of 1926, c. 27, 44 Stat. 9, 12:

SEC. 203. (a) Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 202, shall be recognized, except as hereinafter provided in this section.

(b) * * *

(3) No gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.

* * * * * *

(e) If an exchange would be within the provisions of paragraph (3) of subdivision (b) if it were not for the fact that the property received in exchange consists not only of stock or securities permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then—

(1) If the corporation receiving such other property or money distributes it in pursuance of the plan of reorganization, no gain to the corporation shall be recognized from the exchange, but

(2) If the corporation receiving such other property or money does not distribute it in pursuance of the plan of reorganization, the gain, if any, to the corporation shall

be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property so received, which is not so distributed.

* * * * * *

(h) As used in this section and sections 201 and 204—

(1) The term "reorganization" means (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation), or (B) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred, or (C) a recapitalization, or (D) a mere change in identity, form, or place of organization, however effected.

(2) The term "a party to a reorganization" includes a corporation resulting from a reorganization and includes both corporations in the case of an acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation.

(i) As used in this section the term "control" means the ownership of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of the corporation.

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